Comments on Discussion Draft on Reforms to Oversight of Charitable Organizations

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Introduction

The Council on Foundations is a membership association of more than 2,000 grantmaking foundations and corporations worldwide. For 55 years, the Council has served the public good by promoting and enhancing responsible and effective philanthropy.

This paper comments on several of the many issues addressed in the discussion draft released by the Senate Finance Committee shortly before the June 22 hearings on tax-exempt organizations. Our approach in this paper is to focus on several key issues that particularly affect grantmaking institutions. In doing so, we recognize that there are many issues on which we are not commenting that also could have a profound impact on our members. However, we believe that papers being submitted by other umbrella organizations, including Independent Sector and Board Source, will take up those issues.

We have also elected not to try to address the proposed donor-advised fund reforms identified in Part A.2 of the discussion draft at this time (we do address the proposal that private foundations be barred from making grants to donor-advised funds). Although we believe that we will be able to support some of the recommendations, others cause us concern. We have met, and are continuing to meet, with Committee staff and others to clarify the nature of the abuses that underlie these recommendations in the hope that we may be able to offer constructive alternatives to those. We will submit a separate paper on donor-advised funds at the earliest possible opportunity. As more fully described later in the paper, we will also be submitting additional comments on Type III supporting organizations.

Private Foundation Compensation and Administrative Expenses

Questions about administrative expenses have been at the forefront of discussion of problems affecting tax-exempt organizations. The issues range from what constitutes administrative expenses, to how they are reported, and finally to how much is too much. The Council and its members are committed to doing our part to put an end to illegal and unethical behavior on the part of those who are charged with the governance of the country's foundations. We have described our newest initiative in this regard in the statement we submitted for the record of the June 22 hearing and we will not repeat that information here.

Voluntary efforts will help reinforce adherence to high ethical standards at the many foundations that carry out their activities in keeping with the trust the public places in them. But, Council members agree with the need to strengthen and improve the laws that govern private foundations and the reporting obligations that follow from those laws. We also believe that the IRS must be given the resources it needs to enforce those laws fairly and effectively.

There are approximately 62,000 private foundations in the United States. This grouping includes organizations that have many different characteristics, goals, and means of pursuing them. The largest private foundation has more than $20 billion in assets; the smallest have less than $100,000. Some are organized as charitable trusts and may be governed by a single trustee; others are nonprofit corporations with boards of various sizes. Foundations can carry on their charitable work entirely through grantmaking, through a combination of grants with charitable activities that their staffs carry on directly, or primarily through the operation of charitable programs. The focus of a foundation's charitable activities can be as narrow as a single neighborhood or as broad as the world. Foundation governance may rest in the hands of their donors – those who gave the private wealth that created them – and members of the donors' families; it may be given to an institutional trustee, such as a bank or trust company; it may reside in a board that that includes both family and non-family members; or it may be placed in the care of independent boards with no familial or business ties to the foundation's donor. It is precisely this diverse array of philanthropic activity that makes drawing bright lines, as legislation is likely to do, so difficult.

But we accept that a balance must be struck between the desirable legislative goal of simplicity and the equally desirable goal of avoiding legislation that inadvertently condemns activities that are desirable and should be encouraged along with those that should be struck down and penalized. In that spirit, we offer several suggestions and modifications to the sections of the discussion draft that address compensation and administrative expenses.

Administrative Expenses

The draft includes major proposals with respect to board compensation, staff compensation and administrative expenses. All three are important, but we believe that the administrative expenses proposals are central to strengthening the laws and improving the reporting obligations of private foundations.

One of the many problems with Form 990-PF has been a lack of uniform standards for reporting foundation administrative expenses. This problem makes it very difficult to benchmark private foundation administration expenses. To rectify this, we support efforts that are already underway within the private foundation community to devise common definitions and standards for accurately reporting administrative expenses. If this effort is successful, we would also support importing the new definitions and reporting standards to Form 990-PF to ensure that all foundations report their expenses the same way.

Recognizing that it may take some time to complete the work of improving reporting standards, the Council's board has voted to support the concept of requiring enhanced reporting of administrative expenses by foundations that exceed a threshold percentage and to support the concept of disallowing administrative expenses exceeding 35 percent of total expenses as a qualifying distribution in calculating foundation payout.

Turning this concept into legislation will require resolution of several issues. First, the term "total expenses" must be defined. We are uncertain, for example, whether the term was meant to include or exclude the costs a foundation incurs in managing its investments. Because investment management expenses are reported separately on Form 990-PF, and do not count toward payout, we recommend that the definition exclude those amounts. Second, the definition of what is a "grant to a charity" also needs to be considered. Strictly speaking, program-related investments (PRIs) are not grants; nonetheless, they are like grants in that they are disbursements to organizations outside the foundation that are intended to support the work of those organizations. We recommend that they be treated the same as grants in any legislative proposal. We also recommend the same treatment for grants and PRIs to organizations that are not charities, but that are made to accomplish charitable purposes and comply with the requirements of section 4945 of the Internal Revenue Code. Finally, we recommend that the concept of "grants to a charity" include amounts paid to acquire assets for charitable use and amounts set aside for future charitable distribution in accordance with the applicable regulations.

The issue of direct charitable activities is more difficult. Although Form 990-PF contains lines for reporting the most important such activities, the form does not have a line on which to report total direct charitable activities and expenditures for these purposes are classed as administrative expenses on the form. Nevertheless, projects that a foundation carries on directly are just as much a part of the foundation's charitable program as its grants. We recommend that expenditures for direct charitable activities, as that term is defined in Treas. Reg. section 53.4942(b)-1(b)(1), be excluded from administrative expenses.

As we have discussed, current reporting standards for administrative expenses are not uniform. Until reporting improves, it will be difficult to use existing data to clearly benchmark normal and appropriate administrative expenses and to differentiate them from those that are likely to be excessive. However, even with standardized reporting, the ratio of administrative expenses to total will differ among foundations depending on such factors as their size, whether they have paid staff, the scope and scale of their grantmaking, the kinds of grantees they fund, and, under current reporting standards, the extent to which they directly carry on charitable programs in comparison to the scope of their grantmaking. To cite just a few examples, the costs of administering a global grantmaking program are far greater than those of a similar grant program benefiting a small geographic area inside the United States. Foundations with professional staffs cost more to operate than those administered by volunteers. A foundation with a significant direct charitable program is likely to have a larger staff than one that mostly gives grants. Establishing a threshold percentage also requires consideration of the fact that government requirements are increasing the costs of operating a foundation. International grantmakers recently have spent substantial sums to comply with the requirements of Executive Order 13224, which prohibits financial transactions with terrorists and those who support them. If adopted, many of the discussion draft proposals also would increase overhead costs for foundations and other charities.

The public benefit of enhanced reporting should be to identify those foundations that have unusually high administrative expenses in comparison with other foundations that are like them. Those with expenses that significantly exceed the norm could then appropriately be asked to supply additional data to explain why their costs are disproportionately high. Presumably, unconvincing explanations would trigger additional IRS contact, including audits in appropriate cases. However, to achieve this goal, the trigger level for enhanced reporting must be set high enough that it does not sweep within its ambit a substantial number of foundations with expenses that are, for the size and scope of their activities, perfectly reasonable.

By this standard, the figure of 10 percent suggested in the discussion draft is much too low. We do not know why 10 percent was chosen, but it is important to keep in mind that data on the administrative expenses of private foundations frequently includes the many foundations that have no administrative expenses at all because they are run by family volunteers or, as can be the case for corporate foundations, because another entity absorbs those costs. This produces an artificially low number that does not accurately reflect the reasonable real costs of foundation administration. More realistic figures are based on sets limited to foundations with administrative expenses, but even these data – the best currently available – fail to take into account legitimate differences in administrative expense ratios based on the different operating characteristics of foundations.

Given the deficiencies of the data, and the purpose of the proposed rule – to identify outliers – we recommend that the threshold for increased reporting be set at 20 to 25 percent, rather than 10 percent. We concur, however, that 35 percent is a reasonable figure, above which expenses should not be counted as qualifying distributions. In either case, we recommend that reporting not be triggered by expenditures in a single year, because the ratio may vary from year to year due to circumstances beyond the foundation's control. For example, if a large grant has to be postponed from one reporting year to the next because paperwork is not complete, the foundation's administrative expense ratio would be higher than normal in the first year and lower than normal in the second. Averaging costs over a five-year period would offer a more accurate picture of the foundation's activities.

This leaves the question of the information that should be reported in an enhanced reporting scheme. This issue may best be left to regulation, but we urge those making the determination to keep in mind the use of the Form 990-PF as a public disclosure document. As we will discuss later, one of the problems with the existing form is that the requirement for filing certain detailed schedules substantially impairs ease of access to forms filed by larger foundations.

Finally, the discussion draft states that foundations required to file additional information about their administrative expenses should also pay a sliding-scale filing fee to the IRS for processing the additional information. We understand that this is intended to be a modest fee, rather than one that is punitive in nature or that is intended to generate a significant amount of revenue. If this is the case, we do not believe that our members

would object to paying such a fee. However, if the fee is to be substantial in amount or is intended to generate revenue for some of the other activities described in the discussion draft, we respectfully suggest that a way be found to use instead some portion of the $500 million foundations currently pay in excise tax revenue from the tax on net investment income. The Council continues to support reducing the excise tax to a flat 1 percent; however, even with the reduction, the tax still will generate about $350 million a year in revenue to the government.

Compensation

Both state and federal law permit foundations to compensate their board members or trustees, as well as the individuals the foundation employs. However, that law also limits compensation to that which is reasonable in amount and necessary to accomplish the foundation's charitable purposes. Foundations may not pay compensation that is excessive and must disclose compensation paid to board members and officers on Form 990-PF. Excessive compensation is punishable by imposing the penalty excise taxes for self-dealing and by requiring the disqualified person to repay the excess amount.

The IRS applies the same standard to determining foundation compensation that it applies in testing the reasonableness of compensation in other situations. Compensation is judged by what similar organizations pay for similar services in the same geographic area (which can be the nation for larger foundations with national programs).

Board Compensation

Many foundations are blessed with the services of volunteer boards. However, others have concluded that the nature and extent of the work they ask of their boards merits at least a modest fee. We do not believe that the law should be changed to prohibit paying trustee compensation or to limit compensation to an artificial amount that has been judged to be *de minimis*.

However, we do believe that the law governing compensation determinations and the disclosure of compensation can be improved significantly. First, we recommend that Congress consider importing into section 4941, with appropriate modifications, the rebuttable presumption process described in section 53.4958-6 of the intermediate sanctions regulations for public charities. The rebuttable presumption process offers foundation managers a clear, objective process for making compensation decisions. We do believe that the process should be elective as it is in the section 4958 regulations. We think most foundations that pay compensation would use such a process, but we would not want to establish a mandatory process that penalized a foundation with reasonable compensation for having omitted a particular step or for failing to document it sufficiently. In addition, compensation levels at many foundations are quite low. Those foundations may not need to follow the rebuttable presumption process to document that compensation paid is below market.

The rebuttable presumption process cannot be applied to board compensation in its entirety. A board deciding its own compensation cannot be disinterested. Thought needs to be given to devising a mechanism that gives weight to the board's use of comparability

data in assessing proper compensation levels, while perhaps not giving those decisions the same status as decisions by a disinterested board or committee.

Consideration of trustee compensation also must take two common situations into account. The first is institutional trustees. These trustees typically charge a market-rate fee to manage the foundation and that fee is likely to exceed any amount judged to be *de minimis*. However, systematic information about the amount and magnitude of those fees is sparse, at best. The second is the common situation in which the trustees and board members of a foundation carry on the foundation's daily activities as well as provide governance and oversight. Their fees also are likely to exceed any *de minimis* amount. In some cases, trustee fees are paid in order to attract participation from individuals who could not otherwise afford it.

Form 990-PF would be a more useful reporting tool if it were redesigned to identify those situations and to require the inclusion of a reasonable amount of additional information. Institutional trustees, for example, might be asked to identify themselves as such and then to provide basic information about how their fee is determined. Is it based on a percentage of assets and, if so, what is the percentage? Did the trustee provide both investment and foundation management and how are fees allocated between the two? Similarly, foundation board members who act as staff could be asked to separate those duties and record the amount paid for each.

Form 990-PF also would be a more useful check on excessive board compensation if the IRS enforced the requirement that disqualified persons disclose the number of hours they work. The IRS should stop accepting returns that report compensation, but leave blank the box for reporting hours, or fill it with a statement such as "part-time" or "as needed." E-filing should help resolve this problem.

A final Form 990-PF reporting improvement would focus on how certain kinds of compensation is reported. Nonqualified plans, for example, pose problems because in some circumstances the same amount may be reported twice – in the year set aside and in the year actually paid – even though the individual being compensated receives the money only once.

Staff compensation

The Council does not support use of a specific dollar amount to trigger additional reporting with respect to the compensation paid either to disqualified persons or to other staff. As in the case of trustee compensation, we believe that importing the section 4958 rebuttable presumption process would strengthen the process for determining compensation. We also believe that the reporting of compensation by all foundations could be improved.

The discussion draft proposes different compensation standards for different classes of disqualified persons. One group – the substantial contributor and members of his or her family, would be limited to amounts comparable to those paid by the federal government for similar services and would be required to provide additional information on Form

990-PF if that amount exceeded $75,000. In addition, a requirement that compensation exceeding $75,000 be approved in advance by disinterested members of a board may cap family member compensation at $75,000 in the normal situation in which all members of the board are members of the family. Compensation paid other individuals would trigger additional reporting if it exceeded $200,000.

The Council does not support treating family staff differently than non-family staff. Nor do we support the use of federal rates as benchmarks. Quite apart from the complexity of the federal pay system, and the difficulty of comparing the federal benefits package to that typically available at private institutions, we believe that there is a body of data within the foundation community, including the Council's "Grantmakers Salary and Benefits Report" that is more likely to produce appropriate peer-to-peer comparisons.

The Council also does not support use of a fixed dollar amount to trigger additional reporting. There are foundations for which a $200,000 compensation payment would be wildly unreasonable and there are others for which higher payments reflect the level and complexity of the work performed and are entirely reasonable.

We believe that the process and reporting requirements that we are suggesting will act as a brake on excessive compensation. The advent of e-filing will enable the IRS to construct searches that will readily identify compensation that exceeds the norm for foundations of comparable type and size. Targeted follow-up, including audits and the imposition of penalties as appropriate would go a long way toward discouraging the kind of outrageous compensation reported recently in the media.

We turn now to several other proposals in the discussion draft.

Other Issues

Donor-advised Fund Reforms

Pioneered by community foundations and their counterparts at Jewish Federations, advised funds are flexible tools that have found a variety of applications in facilitating billions of dollars in cost-effective grantmaking. As noted in the introduction to this paper, the Council will comment separately on possible changes to the regulation of donor-advised funds.

Supporting Organizations

The Council shares the Senate Finance Committee's concern about abusive transactions involving some Type III supporting organizations. As a first step in addressing these abuses, the Council recently sent a letter (copy attached) to IRS Commissioner Mark Everson asking that the IRS clearly define mechanisms through which a Type III supporting organization would demonstrate, in its initial application for recognition of exemption, that it has the consent of each of the named supported organizations. We also asked that Type III supporting organizations be required to demonstrate each year, as part of Form 990, that each supported organization continues to consent to its identification as

such. Finally, we asked request that the IRS clearly define a process through which a supported organization can notify the IRS that it has discontinued its consent to be named as a supported organization.

The Council is consulting with its members about the controls they maintain for Type III supporting organizations. We plan to provide additional comments on this issue when we have compiled this data.

Revoke Exempt Status for Accommodations to Tax Shelters

The Council supports the concept of penalties for tax-exempt organizations that knowingly allow their tax-exempt status to be misused to facilitate abusive tax shelters. Significant work needs to be done to bring this proposal from concept status to draft legislation and in that regard the Council will defer to more knowledgeable commenters, such as those from the American Bar Association's Tax Section. However, the Council does believe that penalties should be limited to participation in tax shelters that have been listed as such by the Internal Revenue Service and that any rules clearly state what a tax exempt organization should do to avoid sanctions if a completed transaction is subsequently listed by the IRS as an abusive tax shelter.

Increase Taxes for Self-dealing, Jeopardizing Investments, and Taxable Expenditures

The Council continues to support increasing the initial tax from 5 percent to 25 percent and the initial tax on foundation managers, who knowingly participate in an act of self-dealing, from 2.5 percent to 10 percent. This increase makes these penalties equal in amount to those imposed on public charity disqualified persons and managers under section 4958 of the Internal Revenue Code.

However, we ask that an increase in the penalties be accompanied by a modified form of abatement under section 4962 for acts of self dealing that were due to reasonable cause and not willful neglect. First-tier abatement, which is permitted for section 4958 violations, is even more needed for self-dealing if the penalty is to be substantially increased. Unlike section 4958, which bars only transactions with disqualified persons that confer an excessive benefit on the disqualified person, section 4941 penalizes all transactions, including those from which the foundation benefits. For example, a common error involves a foundation sharing office space with a disqualified person that makes a small payment to the disqualified person to cover the shared costs of items such as utilities. The payment is an act of self-dealing even though the foundation received a substantial benefit from its rent-free occupancy compared with the costs it would have incurred had it rented comparable space from a third-party.

We do understand, and we support, the policy interest in preserving the integrity of the ban on self-dealing. Accordingly, we suggest that first-tier abatement be limited to the amount of the penalty increase. That is, all acts of self-dealing would draw a 25 percent penalty (or a 10 percent manager penalty), but abatement could reduce the penalty to 5 percent (or 2.5 percent for managers) if: 1) the act is corrected, and 2) the self-dealing was due to reasonable cause rather than willful neglect.

The Council is examining the other proposals for penalty tax increases. We note, though, that any increase in the tax on jeopardy investments should be accompanied by clear direction to the Internal Revenue Service to revise and reissue the regulations under section 4944 to bring them into accord with modern theories of portfolio investing.

Prohibit foundation grants to donor-advised funds

The Council is concerned that a prohibition on all grants by private foundations to donor-advised funds would unnecessarily limit many beneficial and creative relationships that make use of this relationship in constructive ways that further various public policy goals. Some examples of ways in which private foundations employ donor-advised funds at community foundations and other public charities include:

- Many private foundations, particularly those that are smaller or that infrequently make grants abroad, make use of donor-advised funds at well-established and highly reputable public charities such as Give2Asia (which is allied with the Asia Foundation), United Way International, and Charities Aid Foundation America to do their international grantmaking. These and similar public charities have offices or affiliates in many countries, giving them direct knowledge of and experience with local non-governmental organizations. All have revamped their due diligence procedures to include appropriate safeguards to address the government's concern that U.S. charities may be unwittingly used to funnel support to terrorists. The Council and others have been encouraging less-experienced grantmakers to use donor-advised funds at these and similar charities as an effective, efficient mechanism to insure that this additional due diligence is performed.
- Private foundations also find donor-advised funds to be a useful tool when they engage in collaborative activities with community foundations and other public charities. Private foundations engaged in collaboration around, for example, a local economic development project, can transfer funds to a donor-advised fund at the community foundation, then advise re distributions from the fund as the project progresses.
- Some private foundations make use of donor-advised funds to make grants in geographic areas that are at a distance from the foundation or in subject areas that are less familiar to foundation staff or volunteers. For example, a private foundation may focus most of its grantmaking in one area of the country, but, to honor a donor's intent, may also make grants in another community that can be hundreds or thousands of miles away. These foundations may establish donor-advised funds at the community foundation that serves the distant location in order to take advantage of the community foundation's knowledge of the local charitable community. Similarly, a private foundation that funds primarily in the area of health care, may use a donor-advised fund at an appropriate public charity to gain access to expertise about potential grantees in the arts.
- Community foundations report that private foundations considering terminating their status often begin by establishing a donor-advised fund. This helps them

experience the services and assistance that community foundation staff can provide. Following a "test drive" that may take several years, the foundation board often elects to terminate the foundation by transferring all remaining assets to the donor-advised fund.

We assume that the proposal was not intended to prohibit distributions to donor-advised funds that terminate the foundation's existence, but this should be clarified.

We would be happy to continue to work with staff to better define the abuses at which this proposal is targeted so that we can offer solutions that do not limit the positive and constructive uses that private foundations make of donor-advised funds at responsible public charities.

Require Public Disclosure of Substantial Corporate Gifts

The discussion draft proposes requiring publicly-traded corporations to file annually with the IRS a return showing all gifts that, in the aggregate, exceeded $10,000 if a charitable deduction is claimed by the corporation. During the 2000 debate surrounding corporate disclosure legislation by Rep. Paul Gillmor (R-OH), and again during the 2002 negotiations with regard to Sarbanes/Oxley legislation, the Council supported a requirement that publicly-traded corporations file annually with the IRS a return showing all gifts over $25,000 for which a charitable deduction is claimed by the corporation. We suggested then, and continue to recommend, that the $25,000 amount be adjusted periodically for inflation and that there be flexibility in the timing of disclosure – as long as the report is filed annually, companies should be able to select a filing date that meshes with all of their other filing and reporting obligations. We recommend that the reporting requirement be limited to single gifts exceeding $25,000, since that would substantially reduce the reporting burden. Finally, if accumulation is required, we recommend that gifts made through employee matching gift programs be excluded, again as a way of reducing the recordkeeping and reporting burden, while targeting the reporting to those gifts that have a greater potential for abuse.

Improve Quality and Scope of Forms 990 and Financial Statements

The Council has a long record of supporting changes to the two forms to improve public disclosure and transparency. As we previously discussed, a group of foundation financial officers has been working on proposed clarifications to administrative expense reporting that will offer a more accurate and nuanced view of how private foundations operate. We believe that this work, when complete, will form the basis for significant revisions to Form 990-PF that will make that form much more useful to regulators, researchers, the media and members of the public.

Foundations filing Form 990-PF must include two attachments that add considerable bulk to the filing without shedding commensurate light on the activities of the foundation. Completing lines 10 through 13 of Part II of the Form requires foundations to attach schedules listing all of their investment holdings held at the end of the filing year. The instructions permit the foundation to summarize and report as a single item only two classes of investment – debt securities of the United States government and those of state

and municipal governments. Part IV of the form requires a complete listing of all capital gain and loss transactions during the year. Particularly for large foundations, these two schedules add hundreds of pages of text to the Form 990-PF filing. We believe that the public interest would be equally well served if Form 990-PF were redesigned to permit foundations to submit this information in more summary fashion, while continuing to maintain the appropriate records for inspection at the foundation's offices. Shortening the Form 990-PF schedules also would shorten the download time for viewing Form 990-PF on the foundation's website or at www.guidestar.org, improving public access to these forms.

The Council also supports e-filing for Form 990-PF as soon as that can reasonably be accomplished. E-filing will greatly improve the ability of the IRS to use computer analysis to target returns and transactions that deserve further inquiry or audit.

Permit Information Sharing Between IRS and State Charity Officials

The Council has supported and continues to support changes to the tax code that would remove barriers that currently prevent the IRS and state charity officials from working more closely together. Current provisions intended to protect the privacy of taxpayers prohibit the IRS from sharing information with state agencies other than state tax officials. Because the Attorney General and not tax officials handle state regulation of foundations, current rules do not permit the IRS to coordinate with states on investigations. The Council supports information sharing between the IRS and relevant state charity officials charged with enforcement.